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Markit Commentary

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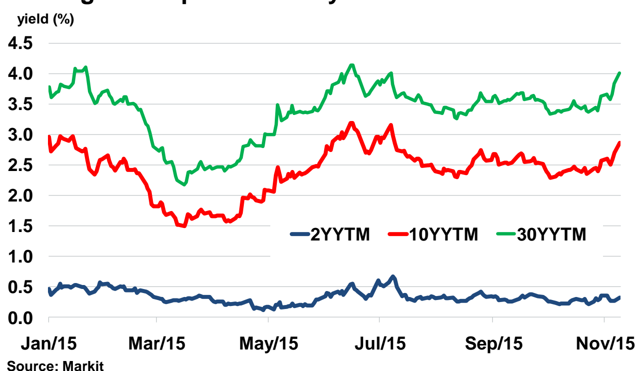
Portugal risks remain isolated among periphery

A populist political coalition looks set to derail Portugal's economic plans, but risks so far remain muted and isolated.

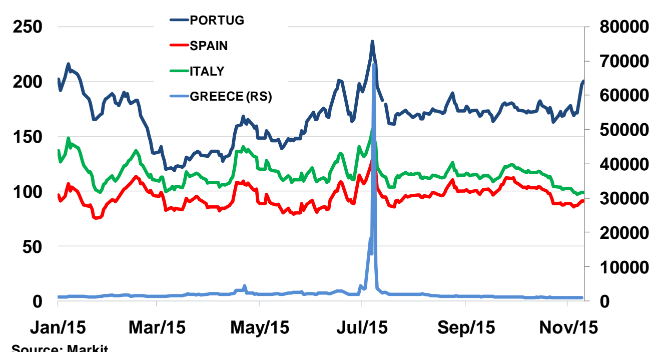
- Portugal's 10-yr bond yield widened to 2.85%, a five month high
- Credit risk in Europe's periphery, Italy and Spain, has shown little signs of contagion so far
- Portuguese CDS trading volumes remain low despite the surging CDS spreads

Five months after Greece gave into pressure from its creditors and agreed to a third bailout, another political upheaval could be daunting the eurozone. Over the weekend Portugal's Socialist party teamed up with fellow leftist groups in an attempt to overthrow the current regime. As we have already seen this year in Greece, Brazil and Turkey, political uncertainty leads to economic uncertainty, and market participants are quick to react.



Yields on 10-yr Portuguese government bonds rose to 2.85% as of yesterday's close, the highest level since July 9th, according to Markit's bond pricing service. Even though yields have since retracted 10bps this morning, they remain 46bps wider than at the beginning of October as political tensions brewed. The shorter end of the Portuguese yield curve, however, remains calmer, with 2-yr yields tightly range bound, suggesting little short term panic as of yet.

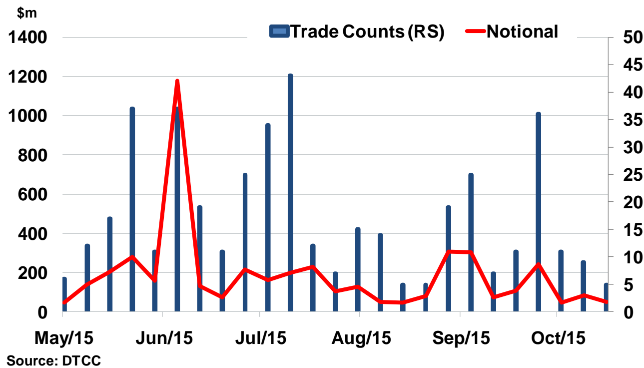
Isolated case



While the events in Portugal naturally draw parallels with the Greek crisis (populist anti-austerity group rising to power), the effect on credit markets has been anything but. Portugal's 5-yr CDS spread, a measure of perceived credit risk, has risen to 200bps, 30bps wider over the past week. But unlike past instances of eurozone disruption, contagion among peripheral names has been absent. Italy and Spain, whose credit risk widened in tandem with Portugal's during July's Greece crisis, has seen 5-yr CDS spreads widen only 2bps and 3bps, respectively, this week.

Expectation of further bond buying from the ECB has helped bring peripheral yields down, keeping risk isolated in Portugal. The eurozone's dynamic has also changed after July's Greek crisis, when Syriza was met by EU hardliners. Any other populist uprisings may also be challenged by the same stiff opposition, which could be another reason signs of contagion are little.

Investors not running for cover



Despite a spike in Portugal's credit risk, CDS investors have so far remained on the side-lines. According to DTCC, notional trading volumes have remained low in comparison to previous bouts of volatility, in July and most recently in August. The political tensions, which have gathered over the past month have yet to unnerve investors, with the CDS trade count actually progressively falling over the last three weeks, suggesting little appetite to hedge credit risk. Whether this picks up remains to be seen, but the data shows the current risks investors adhere to are far more on a macro level than micro.

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